

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 02-0509
Indiana Corporate Income Tax
For the Tax Years 1998, 1999, and 2000

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ISSUE

I. Add-Back of Taxes Based on or Measured by Income – Indiana Adjusted Gross Income Tax.

Authority: IC 6-3-1-3.5(b); IC 6-3-1-3.5(b)(3); Consolidation Coal Co. v. Ind. Dept. of Revenue, 583 N.E.2d 1199 (Ind. 1991); Consolidation Coal Co. v. Ind. Dept. of Revenue, 538 N.E.2d 309 (Ind. Tax 1989); Wash. Rev. Code § 82.04.070; Wash. Rev. Code § 82.04.080; Wash. Rev. Code § 82.04.090; Wash. Rev. Code § 82.04.100; Wash. Rev. Code § 82.04.220; Wash. Rev. Code § 82.04.230; Wash. Rev. Code § 82.04.240; Wash. Rev. Code § 82.04.450; Wash. Admin. Code § 458-20-112; Tax Management Multistate Tax Portfolios (1998).

Taxpayer argues that Washington Business and Occupation (B&O) Tax is not a tax based on or measured by income. Accordingly, taxpayer maintains that the Department erred in requiring taxpayer to add back the Washington tax in order to determine its Indiana adjusted gross income.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of growing, harvesting, manufacturing, and marketing forest products. It grows trees, cuts them down, and turns them into lumber. In addition – through its various subsidiaries – it is also engaged in real estate development, construction, paper production, and the provision of financial services.

The Department conducted a review of taxpayer's business records and tax returns. In reviewing the taxpayer's Indiana returns, the audit review determined that the taxpayer incorrectly failed to add back the federal deduction taken for the Washington B&O Tax. The decision to add back the Washington tax resulted in an assessment of additional Indiana income tax. The taxpayer disagreed with the Department's decision and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer further explained the basis for its protest. This Letter of Findings results.

DISCUSSION

I. Add-Back of Taxes Based on or Measured by Income – Indiana Adjusted Gross Income Tax.

When a taxpayer calculates its federal taxable income, it is entitled to deduct state and local taxes pursuant to I.R.C. § 164. However, in calculating its Indiana adjusted income, taxpayer begins with federal taxable income as defined under I.R.C. § 63 but is thereafter required to make certain adjustments. IC 6-3-1-3.5(b).

One of these adjustments is found at IC 6-3-1-3.5(b)(3) which requires that the taxpayer “[a]dd an amount equal to any deduction or deductions allowed or allowable pursuant to Section 63 of the Internal Revenue Code for taxes *based on or measured by income* and levied at the state level by any state of the United States.” (*Emphasis added*). A corporate taxpayer can deduct state and local income taxes when calculating its federal adjusted income; it may not do so for Indiana income tax purposes.

When taxpayer calculated its Indiana income tax, it decided that it was unnecessary to add back the amount of money it paid as Washington B&O Tax. It did so because taxpayer determined that this particular state tax is not a tax “based on or measured by income.” According to taxpayer, the Washington B&O tax is a “privilege tax based on various business activities.” In support of that contention, taxpayer cites to Wash. Rev. Code § 82.04.220 which states:

Business and occupation tax imposed. There is levied and shall be collected from every person a tax for the act or privilege of engaging in business activities. Such tax shall be *measured* by the application of rates against the *value* or products, *gross proceeds* of sales, or *gross income* of the business, *as the case may be*. (*Taxpayer’s emphasis*).

Taxpayer agrees that under the Washington B&O Tax, the income received by retailers and wholesalers is measured by income. However, taxpayer argues that when the Washington B&O tax is levied on “extracting” and “manufacturing” activities, the amount of the tax is not based on income. Because taxpayer maintains that it is primarily in the business of “extracting” and “manufacturing,” it should not be required to add back the Washington B&O Tax assessments imposed against those particular activities.

Washington State levies a gross receipts tax imposed on “the privilege of engaging in business.” Tax Management Multistate Tax Portfolios 1610:0001 (1998). The most obvious difference between a gross receipts tax – such as the Washington B&O Tax – and a net income tax is in the number of deductions allowed; a gross receipts tax permits only limited deductions. Id. In addition, the Washington B&O Tax – unlike a net income tax – reaches all levels of the production and distribution process. Id.

Taxpayer is correct in that the Washington B&O tax is imposed on the “extraction” of natural resources from “the person's own land or from the land of another under a right or license granted by lease or contract.” Wash. Rev. Code § 82.04.100. Taxpayer is also correct in that the tax is assessed against in-state manufacturing activities measured by the ultimate sales prices less

transportation costs. Wash. Admin. Code § 458-20-112. Washington's tax scheme avoids the constitutional prohibition against taxing proceeds stemming from out-of-state sales by "merely mov[ing] back one step in the commercial process and plac[ing] a tax upon the extracting or manufacturing of the goods, instead of upon their sale." Multistate Tax Portfolios 1610:0004. In those instances in which a taxpayer is involved in multiple activities – extracting, manufacturing, retailing – Washington taxes the last activity to occur in the chain. Id. at 1610.0029.

The issue is whether the Washington B&O tax – including those portions of that tax levied against "extracting" and "manufacturing" – are based on or measured by income. The Indiana Supreme Court addressed the add-back issue in Consolidation Coal Co. v. Ind. Dept. of Revenue, 583 N.E.2d 1199 (Ind. 1991). In doing so, the court stated the "the phrase 'based on or measured by income' seems likely to be used in the same simple sense which defined the issue in Miles. Is the tax which payor wishes to add back measured by income? Or measured by value of property held?" Id.

Washington imposes its tax on the "gross proceeds of sales," the "gross income" of the business," and the "value proceeding or accruing" depending on the type of activity producing the income. Wash. Rev. Code § 82.04.070, .080, .090. For example, Washington imposes a tax equal of 0.484 percent on the "value of the products, including byproducts, extracted for sale or for commercial or industrial use." Wash. Rev. Code § 82.04.230. Similarly, the state imposes the identical rate of tax on manufacturers based upon "the value of the products, including byproducts, so manufactured regardless of the place of sale or the fact that deliveries may be made to points outside the state." Wash. Rev. Code § 82.04.240. The value of the manufacturer's products is "determined by the gross proceeds derived from the sale thereof whether such sale is at wholesale or at retail" Wash Rev. Code § 82.04.450.

The Department concludes that the money paid by extractors or manufacturers pursuant to the Washington B&O Tax is attributable to a tax based on or measured by the taxpayer's income and is not based on the value of property. The Washington B&O tax is reasonably comparable to the West Virginia Business and Occupation Tax considered by the Tax Court in Consolidation Coal Co. v. Ind. Dept. of Revenue, 538 N.E.2d 309 (Ind. Tax 1989). In determining that the West Virginia tax should be added back in order to calculate Indiana adjusted gross income, the court compared the West Virginia Tax to Indiana's own Gross Income Tax and stated that, "[T]he tax in question is an excise tax levied upon those domiciled within the state, or who derived income from sources within the state, upon the basis of the privilege or domicile or the privilege of transacting business within the state, and . . . the burden may reasonably be measured by the amount of income." Id. at 311. The language quoted by the court in Consolidation aptly describes the Washington B&O Tax.

In calculating its Indiana adjusted gross income, the taxpayer is required under IC 6-3-1-3.5(b) to add back to its federal taxable income any deduction taken for taxes paid to Washington under that state's Business and Occupation Tax.

FINDING

Taxpayer's protest is respectfully denied.

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